



The benefits, revenue cost, and implications for individuals and the economy of abolishing the contributions tax

Ross Clare
ASFA Research Centre

March 2006

**Federal
Secretariat**

Level 19
Piccadilly Tower
133 Castlereagh St
Sydney NSW 2000

PO Box 1485
Sydney NSW 1005
Tel: (02) 9264 9300
Fax: (02) 9264 8824

Foreword

The key objectives underlying government assistance for retirement income provision are to encourage savings, help ensure adequate and sustainable retirement incomes and to treat individuals equitably both in their working life and in retirement. Currently and for the foreseeable future most individuals will rely on a mixture of private savings (principally superannuation) and the government provided Age Pension for their income in retirement. While private savings provide a supplement to the Age Pension and are important in achieving adequacy of retirement incomes, they also have the effect of reducing reliance on social security. Without sufficient private retirement savings there would be growing pressure to increase the relative level of the Age Pension, with significant Budget implications.

In recent years the government has made a number of significant and welcome reforms to superannuation. Some additional steps could further enhance Australia's position and that of individuals planning for retirement.

Removal of, or reduction in, the tax on super contributions would improve adequacy of retirement income for the majority of Australians. Abolition of the tax would help mitigate the fiscal effects of the demographic ageing of our population, by bringing the level of taxation of retirement savings in Australia more in line with those of most OECD countries. Currently contributions to superannuation in Australia face the third highest effective rate of taxation on retirement savings in the OECD after Denmark and New Zealand. This is not an enviable international ranking.

Calls to remove or reduce the tax on contributions have had a long history with many respected commentators supporting its removal. The issue has again been firmly placed on the public agenda following ASFA's release of its Pre-Budget Submission in December 2005 and since Senator Nick Minchin, the Minister for Finance, canvassed the potential benefits of ASFA's proposal in a speech he made in January 2006.

This paper draws some important conclusions. It shows that the cost to Commonwealth revenues of removing the tax would be very affordable in the context of prospective Budget surpluses. This is in no small part due to good fiscal management by the present government. The run of surpluses in recent years means the revenue-raising imperative for which the contributions tax was itself created is gone.

The priority is now to boost the retirement savings of an ageing population and ensure a viable future economy, something the government is well placed to do.

The paper also demonstrates that the outcome would be very equitable, improving adequacy of retirement savings and incomes, with the bulk of benefits flowing to low and middle income earners. It shows that the impact on national savings would be largely neutral compared to the Commonwealth having a higher Budget surplus, and strongly positive compared to a personal income tax cut costing a similar amount.

Importantly in the context of the Government's current review of how Australia's tax system compares to other countries, the paper shows that Australia stands alone in taxing superannuation at each of the contributions, fund earnings, and benefits stage

compared to the usual practice of only taxing at the benefit stage, with the overall effective tax rate being high as well.

The virtues of removal of the contributions tax have been widely recognised within the community, and this paper provides further clear and documented support for the proposal. The time is ripe for the government to build on the strong economic position it has achieved and invest in the future.

Philippa Smith
Chief Executive Officer

Executive summary

Australia's three pillar structure combining compulsory and voluntary superannuation together with the age pension safety net, provides a sound base for retirement funding, and is often cited internationally as best practice.

A number of recent reforms, for which the government is to be congratulated, include the abolition of the superannuation surcharge, introduction of co-contributions for lower income earners, and more flexibility for the transition from work to retirement.

But while the superannuation infrastructure is generally sound, most individuals will still fall financially short of their expectations and needs in retirement. The effects of the demographic ageing of Australia's population present both an economic and a social challenge for government and the community.

In order to better meet these challenges, saving needs to be encouraged. Research continually shows that the taxes on super, and in particular the contributions tax, act as a disincentive to saving. The contributions tax is viewed as unfair and inequitable by the community.

There is now a window of opportunity to bring the super contributions tax to an end.

This research paper establishes that abolishing the tax associated with superannuation contributions is:

- affordable;
- equitable (on both an individual and intergenerational basis);
- would lead to substantial benefits including more adequate retirement incomes for the bulk of the population;
- would have a more favourable impact on national savings than any other conceivable Commonwealth budgetary measure; and
- would boost investment in the Australian economy.

This study also demonstrates that saving for retirement through superannuation is taxed relatively highly by OECD standards, with Australian Treasury estimates of tax expenditures on superannuation systematically overstating the true level of assistance.

Revenue cost of abolishing the contributions tax

While there are some practical difficulties in estimating the cost to revenue of abolishing the tax on employer and other deductible contributions, a reasonable estimate for 2006-07 is around \$3.3 billion. This is based on total tax collections from superannuation funds and the superannuation business of life companies of around \$6.3 billion, with the tax attributable to superannuation investment earnings estimated at a very conservative \$3 billion. There have been higher estimates of the cost of abolishing the contributions tax by opponents of its abolition, but in fact such estimates are not consistent with aggregate investment earnings and total tax collections related to superannuation.

ASFA considers that in the current economic and financial environment, with a Budget surplus likely to exceed \$10 billion, there is clear scope to deliver a tax cut in the form of the abolition of the tax on superannuation contributions. This would be consistent with the Charter of Budget Honesty.

Intergenerational equity and the contributions tax

Since 1988 successive governments have brought forward the collection and spending of taxation revenue from super. If there had been no contributions or investment earnings taxes, then current superannuation balances would have been some \$115 billion higher in aggregate. With the share of the population aged over 65 set to almost double from 13% to 24.5% over the next 40 years, it would have been economically sounder to leave this money in superannuation so as to better equip individuals and society to cope with this inevitable demographic change.

Taxation of super in Australia relative to overseas practice

The Treasurer has recently commissioned a review of taxation levels and rates in Australia relative to overseas. In this context it is important to note that Australia stands alone in taxing superannuation at each stage of contributions, investment earnings, and benefits (albeit at concessional rates). In comparison, the vast majority of OECD countries exempt contributions and investment earnings, and only tax at the benefits stage.

OECD research also shows that when tax at each stage is taken into account, the overall average effective tax rate in Australia on saving through superannuation is around 20%, the third highest rate after Denmark and New Zealand.

The paper also points to systematic upward biases in the Tax Expenditure Statement, and estimates that the true figure for assistance to superannuation is more in the order of \$10 billion to \$11 billion rather than the \$15.5 billion claimed by Treasury. The OECD analysis also shows that when correctly calculated, the cost of tax expenditures on superannuation in Australia is modest, especially given the greater reliance on private provision for retirement in Australia compared to other countries. In many other countries the cost to the government of age related income payments is well over 10% of GDP. In Australia the current cost of Age and Veterans Pensions is around 3% with another 1.6% of GDP devoted to superannuation tax concessions.

Individual benefits from abolishing the contributions tax

For a person on a wage of \$50,000 per year, the direct impact of abolishing contributions tax would, over a thirty year period, increase their retirement savings by around \$27,500 in terms of today's dollars. This would represent a very significant increase in their retirement savings, around 16%.

Removal of the contributions tax also would generate additional savings through providing an effective incentive for lower and middle income earners (and others with superannuation) to arrange for salary sacrifice or other tax deductible contributions to be made on their behalf. For those on a 30 cents in the dollar personal income tax rate, abolition of the contributions tax would make salary sacrifice a viable proposition.

National savings

Of all possible Commonwealth budget tax or expenditure proposals, elimination of the tax on superannuation contributions is the measure most likely to generate an increase in national savings, or at least no significant diminution. Private savings will also unequivocally increase. Abolition of the contributions tax would boost private savings by at least \$2 billion, compared to only \$430 million for an equivalent cut in personal income tax. Abolishing the contributions tax would have favourable effects on the level of funds available for investment in the Australian economy.

Equity impacts and creating incentives

The great bulk of the benefits of abolition of the contributions tax would flow to low and middle income earners. Nearly 70% of superannuation contributions are made by or on behalf of individuals who will be on a marginal tax rate of 30 cents in the dollar or less after 1 July 2006.

Abolition of the tax would reverse the squeezing of incentives that have occurred in recent years. Compared to five years ago, after 1 July 2006 the volume of superannuation employer contributions for employees on the top marginal tax rate will be down from 28% to 11%. On the other hand, the proportion of contributions where the employee is on a marginal income tax rate of no more than 30% will have increased from around 62% to 67%. As a result, the average weighted marginal personal income tax rate of superannuation fund members will have come down from about 39% to around 34%.

Currently for the majority of Australians there is little incentive to save for the longer term.

The distribution of contributions by level of household wealth

Superannuation is particularly important for middle income households, since it, together with life insurance, accounts for around 55% of household financial assets, with relative importance lower for the wealthiest quintile. The wealthiest quintile has substantial holdings of equity investments and trusts, with the poorest quintile having very low levels of these.

Removing tax from superannuation contributions would have the potential to reduce wealth inequality as it would have its greatest relative impact at the lower ends of the wealth distribution.

Design features of the system bringing about equitable outcomes

The very few critics of the proposal to abolish the contributions tax have raised concerns about the equity of the proposal. However, there are a number of design features of the superannuation system which would prevent an excessive level of contributions made by or on behalf of upper income earners.

These measures include the tax free threshold for benefits, the means test applying to the Age Pension, and the Reasonable Benefit Limits on superannuation benefits. While what is in place is not straightforward, it does more or less adequately deal with equity. Removing the tax on contributions would enhance adequacy of retirement incomes without compromising equity considerations.

Individuals with low balances of superannuation (less than \$129,751) pay no benefit tax on their superannuation payouts, and they also generally will receive the full Age Pension. Those with moderate levels of superannuation will pay a modest amount of benefit tax and generally will receive a part Age Pension. Those with relatively large superannuation benefits pay a significant amount of benefit tax on a lump sum or pay ongoing income tax (albeit at a concessional rate) on an income stream, receive no Age Pension and face withdrawal of tax benefits on any amount over the applicable Reasonable Benefit Limit.

1. Cost to Commonwealth tax collections of abolishing taxation of superannuation contributions to funds and life companies

An important starting point in considering the costs and benefits of removing the tax on superannuation contributions is estimating the likely implications for Commonwealth taxation revenue. While all forward estimates of expenditure and revenue involve some difficulties, the characteristics of the taxation of superannuation make estimating the revenue impact of abolishing the tax on superannuation an exercise in which considerable care needs to be taken.

1.1 Practical and theoretical challenges of estimating revenue impact

Calculating the cost to Commonwealth revenue from abolishing the tax applied to employer and other tax deductible superannuation contributions is not an easy task. One practical problem is that there is no summary estimate in the Budget papers or in any publication from the Australian Taxation Office that provides a direct measure of the amount of tax collected which is attributable to such contributions.

There are a number of reasons for this. First, no split is available between the contributions and fund earnings components of the tax from superannuation funds. There is one unified tax on superannuation funds, rather than separate taxes on contributions and fund earnings, although this may not be obvious to individual fund members who see a specific adjustment for “contributions tax” on their annual superannuation member statement. This adjustment is just part of the internal cost distribution of superannuation funds, rather than an amount deducted and sent direct to ATO like PAYG income tax.

In regard to the dealings between superannuation funds and the ATO, both taxable contributions and investment earnings form the total taxable income of superannuation funds, and from this total taxable income various deductions are made. Some of these deductions are attributable to the contributions received, with others linked to the earning of investment income.

Second, the published figures relating to superannuation tax collections only cover superannuation funds and not the superannuation business conducted directly by life insurance companies. When life insurance companies conduct superannuation business the relevant superannuation related tax is collected as part of company tax collections from the life insurance companies, albeit at the superannuation fund rate rather than the company tax rate. From published data it is not possible to establish the extent of each component or, more importantly for this exercise, the extent and composition of taxation related to their superannuation business.

Third, the detailed ATO data dealing with components of superannuation fund income and expenses are only available up to 2002-03, making estimates for later years for detailed income and expense items problematic.

Fourth, if the contributions were no longer taxable, there would be changes to both the taxable income and the deductible expenses of superannuation funds, with the net cost to revenue much less than total taxable contributions times a 15% tax rate. For instance, there are very substantial deduction items available to funds which are attributable to contributions income, but which would not be attributable or deductible against investment earnings of funds. More specifically, in 2002-03 official ATO statistics show that superannuation funds had around \$13 billion in expenses that were attributable to contributions (ATO, 2005). Some of the larger deductible expenses included transfers of tax contribution (generally to Pooled Superannuation Trusts and to life insurance companies), life and disability insurance premiums, and still quite large amounts for pre-1988 funding credits (where mainly public sector funds claim deductions for employer contributions relating to pensions which started prior to 1988). The administration costs of the funds are also deductible.

Fifth, there would be additional investment earnings of funds as a result of higher member account balances due to tax no longer being collected in regard to contributions. This would lead to higher tax collections from investment income of funds, and would also lead to increases in the amount of benefit tax collected from individuals when superannuation benefits are finally paid.

Sixth, there are likely to be some behavioural changes if the contributions tax were removed, with more employer contributions made as a result of salary sacrifice arrangements. However, the Commonwealth Treasury often considers that employer superannuation contributions are unresponsive to tax changes, for instance claiming that the superannuation surcharge had little effect on the amount of contributions made. The reality is likely to be significant but not over the top increases in contributions if the tax on contributions is removed. As will be discussed later in this paper, lower income individuals tend to be constrained by the level of their income in their capacity to make additional contributions, and higher income earners balance the tax advantages of superannuation with factors such as preservation arrangements and the attractiveness of other tax advantaged investment approaches such as negative gearing.

1.2 Total tax collections from superannuation

A starting point for the cost to revenue of removing the contributions tax is the amount of tax attributable to superannuation that is collected from superannuation funds and life companies in regard to both contributions received and investment earnings. It should be clearly noted that this is nothing like the amount you would calculate by multiplying superannuation fund taxable income times a 15% tax rate.

Table 1 provides such estimates based on Treasury and ATO figures for superannuation funds linked to the amounts actually collected, and ASFA Research Centre estimates for life insurance companies. The Research Centre figures assume that around 15% of total superannuation tax collections are in the form of company tax paid by life insurance companies. This is down from the 20% figure which a number of sources suggest Treasury applied in the mid-1990s (Access Economics, 1998). The reason for this adjustment is that increasingly retail superannuation is provided outside the life insurance company structure. As a result of this and a number of other factors, currently around 26% of total superannuation assets are invested in life company funds, compared to around 38% in the mid 1990s.

Table 1: Total taxation revenue (cash basis) derived from superannuation contributions and investment earnings

Year	From funds	From life insurance companies	Total
	\$m	\$m	\$m
2003-04	4 502	795	5 297
2004-05	5 080	895	5 975
2005-06	5 280	930	6 210
2006-07	5 360	945	6 305

Source: 2005-06 Budget Papers; 2005-06 Mid-Year Economic and Fiscal Outlook; and ASFA Research Centre estimates

1.3 The split of taxable income between contributions and fund earnings

If no tax were collected at all in regard to the investment earnings of superannuation then the revenue cost of abolishing the contributions tax would be around \$6.3 billion. However, there is considerable investment income included in the taxable income of superannuation funds, and considerable tax revenue for the government from this. Investment income currently exceeds \$70 billion a year, with fund tax deductions in regard to this fairly limited. The main investment deductions are investment management costs and income attributable to current pension liabilities, and these together do not exceed \$5 billion a year.

Treasury and others generally assume an effective tax rate on superannuation fund investment earnings of 6.5% (Rothman, 2003). This allows for the impact of imputation credits and capital gains tax concessions for assets held for more than 12 months. If anything this effective rate should be drifting up over time given the increasing tendency of funds to make investments such as overseas investments, property, hedge funds and private equity which do not attract imputation credits.

Applying an effective tax rate of 6.5% to \$65 billion net investment earnings implies taxation revenue attributable to investment earnings of \$4.2 billion. This suggests that the cost to tax revenue of abolishing the contributions tax would be under \$3 billion a year. **Allowing for some behavioural change and providing a buffer for uncertainty in the estimates leads to a revenue projection of the cost of removing the contributions tax of around \$3.3 billion in today's terms.** Over time there would be some offsets to this amount as well in the form of increased revenue from investment earnings (due to the increase in the amount invested) and from lump sum tax on final benefits. However, in the early years the offsets would only be in the scores of millions, rather than hundreds of millions. However, after 30 years or so, when the Commonwealth Budget might need considerable assistance given the impact of demographic ageing, this revenue effect would be substantial.

Higher revenue costs could be obtained by assuming large behavioural changes, but as the next section indicates there are a number of factors which will limit the extent to which additional contributions are made and avoid the proposed removal of

contributions tax being misused. More specifically, the age based contributions limits together with the overall Reasonable Benefits Limits will contain the amount of contributions that can be made. As well, preservation of benefits in most circumstances to at least age 55 (increasing to age 60) means that voluntary contributors have their long term retirement savings in mind when they contribute, with superannuation contributions being in no way a quick fix for a tax problem. High income individuals look other than to superannuation when they want to lower their tax bill but still have access to their cash.

1.4 Other estimates of revenue costs, the prospective Budget surplus and the Charter of Budget Honesty

Treasury officers have indicated, in evidence on 10 February 2006 to the House of Representatives Economics, Finance and Public Administration Committee inquiry into improving the superannuation savings of those aged under 40, that they consider abolition of the tax on contributions would cost more than \$3.3 billion a year. However, no figures or costings were provided by them. In the past ASFA's costings of revenue associated with superannuation have proven to be accurate, and in the absence of any better particulars remain valid.

While ASFA does not wish to engage in the debate about the exact extent to which the Commonwealth Government has the capacity to reduce taxes or increase spending, it considers that in the current economic and financial environment there is clear scope to deliver a tax cut in the form of the abolition of the tax on superannuation contributions. A prospective Budget surplus of well over \$10 billion, perhaps in the order of \$14 billion, has been widely canvassed, and this indicates that a tax cut for superannuation of over \$3 billion or even over \$4 billion is very affordable.

A superannuation tax cut would be totally consistent with the intent of the Charter of Budget Honesty (see box below). It would not lead to government debt being at anything other than a prudent level, and it would, in contrast to just about any other feasible tax cut, lead to little if any diminution in the level of national savings (see section 4 below).

It also would be a decision which would have a favourable financial impact on future generations as it would improve retirement income adequacy for future generations and reduce demands on future government expenditure in regard to the Age Pension.

Responsible budget policy can involve appropriate taxation cuts, rather than increasing or excessive budget surpluses. In ten Budgets since 1996-97 there have been eight surpluses cumulating to an estimated \$59 billion over 10 years. Commonwealth net debt will, this year, be eliminated. Net interest payments which were \$8.4 billion (1.5% of GDP in 1996-97) will fall to \$0.3 billion in 2006-07 (0.0% of GDP). In subsequent years net interest payments are projected to be negative (Costello, 2006). There is both scope and need for tax relief, rather than yet another very large Budget surplus.

Charter of Budget Honesty Act 1998: Principles of sound fiscal management

Fiscal policy should be directed to maintaining the ongoing economic prosperity and welfare of the people of Australia and therefore should be set in a sustainable medium-term framework. To meet these objectives, a government should frame its fiscal strategy in accordance with the following principles of sound fiscal management. The government should:

manage prudently the financial risks the Commonwealth faces, including by maintaining Commonwealth general government debt and contingent liabilities at prudent levels;

ensure that fiscal policy contributes to achieving adequate national saving and, as appropriate, to dampening cyclical fluctuations in economic activity, taking account of the economic risks the nation faces and their impact on the Commonwealth's fiscal position;

pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of tax burden;

maintain the integrity of the tax system; and

ensure that policy decisions consider their financial effect on future generations.

1.5 Removal of the contributions tax in the context of other Government superannuation measures

Removing the tax on contributions would also complement and build on other important initiatives of the Government which will assist in bringing about greater adequacy of retirement income. These initiatives include:

- the extension of the co-contribution to those earning up to \$58,000 a year and an increase in the rate of the co-contribution;
- the abolition of the superannuation surcharge;
- changes to and simplification of the rules relating to contributions and cashing out of balances for older workers;
- allowing all Australians to contribute to superannuation;
- transition to retirement arrangements; and
- contribution splitting between spouses.

2. Intergenerational equity and abolishing the contributions tax

Since 1988 successive governments in Australia have brought forward substantially the collection (and spending) of taxation revenue from super.

If these taxes had been left to grow in member accounts then retirement savings would now be some \$105 billion higher through higher net contributions and subsequent additional investment earnings. There has also been \$7 billion in surcharge collections since 1997-98, which on top of their direct impact have also reduced investment earnings.

An additional \$115 billion or so in the system from an absence of taxes on contributions and fund investment earnings would have helped to provide more adequate retirement incomes, would have reduced pressures on government expenditures on the Age Pension, and through the taxation of end benefits would have strengthened the revenue base of future governments.

In effect, governments have spent this money in advance of when it is really needed to meet the income support and health costs for ageing babyboomers. Access Economics has referred to these emerging costs as a multibillion dollar blackhole (Access Economics, 2004). In terms of intergenerational equity, babyboomers are being required to both contribute to the private provision of retirement and pay taxes, including the tax on superannuation contributions, in order to pay, amongst other things, the current costs of social security and health care for current retirees.

The share of the population aged over 65 years is projected to almost double, rising from 13.0% to 24.5% from 2003-04 to 2044-45. An even bigger relative change is anticipated for the oldest old — those over 85 years. Their share increases from 1.5% to 5.0% over this period. Without retirement income reform the likely combined costs of government spending on aged care, age pensions and health care will jump from the current level of 9.7 % of GDP to over 17% of GDP. On the other hand total government tax revenues are only expected to increase by 0.1% of GDP on the basis of current parameters (all projections from Productivity Commission 2005). This represents a gap between projected revenue and costs of over \$60 billion per year in today's dollars.

Future retirees will have higher expectations of living standards in retirement than current retirees. **In the absence of significantly increased self-provision they will place intense political pressures on future governments, and generations, to fund the living standards that they expect in retirement.**

A respected consulting firm (Rice Walker) has indicated that there is a \$450 billion gap, in current dollars, between the retirement income people expect to have and what the compulsory and voluntary superannuation contributions together with the Age Pension will deliver.

While recent Government initiatives have reduced the prospective size of this savings gap, further action is needed. Abolishing the tax on superannuation contributions and/or expanding the co-contribution would be important steps in this regard, and it would also help redress the intergenerational inequity in funding responsibilities that has emerged.

3. Taxation of superannuation in Australia relative to practices overseas

3.1 Theoretical framework

As noted by OECD researchers (OECD 2004), most OECD governments use tax incentives to encourage the development of private retirement saving plans. In many cases (the norm or base case by international standards) private pension savings (superannuation in the Australian vernacular) are deductible from the income tax base, and the accrued return on investment is exempt from taxation, but pension benefits arising from these savings are taxed. In other cases, the accrued return on pension investment is taxed, but at a preferential rate relative to other forms of savings.

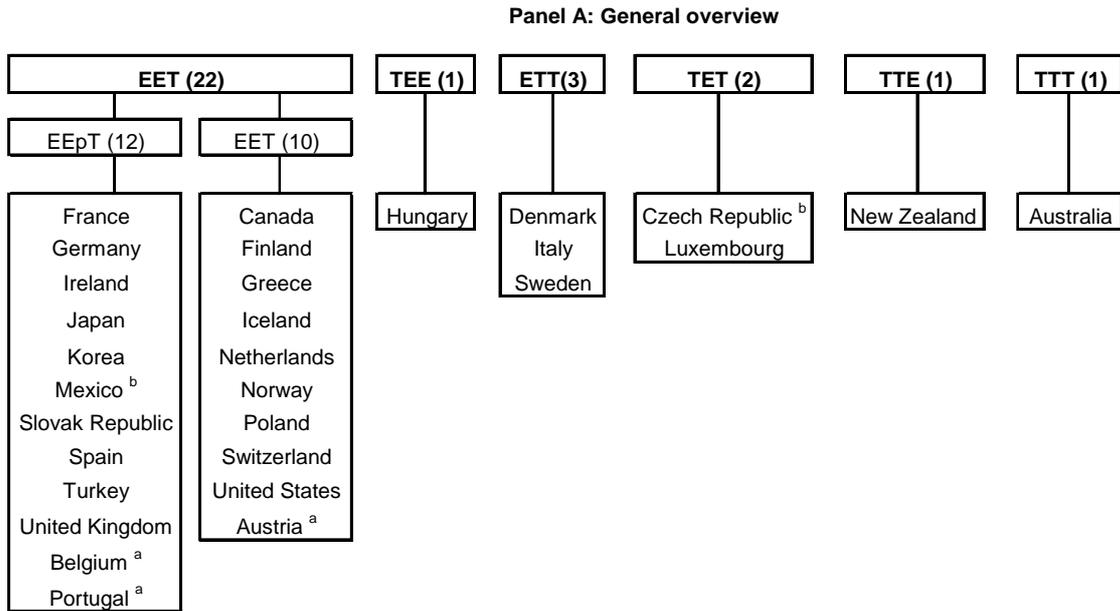
In principle, most savings vehicles, including pension or superannuation funds, involve three transactions that can be subject to taxation:

- When a contribution is made to the savings instrument.
- When investment income and capital gains accrue to the savings vehicle.
- When funds are withdrawn.

A savings scheme is usually considered as being taxed favourably when its tax treatment deviates from a regime that treats all sources of income equally (the so-called *comprehensive income tax* regime). In a pure comprehensive income tax system, savings are made out of taxed earnings and the nominal investment return on funds accumulated is also subject to an income tax. However, the withdrawal of assets from such saving vehicles is fully exempted from taxation. Such arrangements are known as “taxed-taxed-exempt” (TTE) schemes. However, rather than this theoretical benchmark being the normal practice, the standard practice in most OECD countries is for private pensions (superannuation) to be taxed on an EET basis, which means contributions are exempt from tax, fund earnings are exempt from tax, and benefits are subject to normal or concessional income tax rates.

Australia stands alone amongst OECD countries in that it taxes superannuation savings three times. As shown by Table 3.1 (extracted from the OECD paper), while Australia, New Zealand, Czech Republic, Hungary and Luxembourg tax contributions to private pension schemes, only Australia taxes the lot, albeit at more or less concessional rates at each stage. **In the table Australia is out on its own in the treatment of superannuation.**

Table 3.1: Country groupings according to the tax treatment of private pensions



Abbreviations: E (exempt), pT (partially taxed; only in the EET system), T (taxed)

Note:

a) The employee's contributions are partially exempt or receive tax credits in Austria, Belgium and Portugal

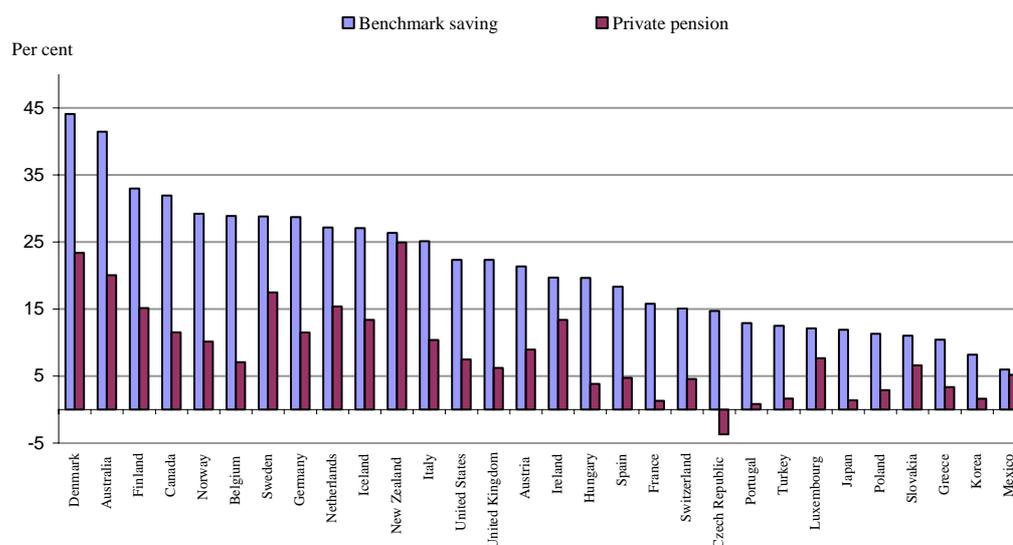
b) Mexico and the Czech Republic provide a state subsidy to contributions

3.2 International comparisons of effective tax rates on saving through superannuation

The OECD publication also provides estimate on effective tax rates on private pension (superannuation) saving. This is calculated by taking into account the totality of taxes at the contributions, investment earnings and benefits stage. A discount rate is also utilised in the calculation to adjust for the fact that the different taxes are taken out at different stages of the savings process. The end result, after the application of some reasonably complex algebra, is a single figure which captures the level of taxation of private pension (superannuation) saving regardless of how it is structured in individual countries. Simpler calculations can be attempted, but they generally will give misleading results as an overall effective tax rate is not simply the sum of tax rates at each stage, especially given that they are collected at different points of time.

In terms of the OECD quantitative findings, **the estimated effective tax rate on superannuation saving in Australia is around 20%, the third highest effective rate for tax preferred retirement savings amongst OECD countries after New Zealand and Denmark (Chart 3.1)**. In this context, Denmark not a usual role model for the taxation of private income. New Zealand may intentionally be aiming to provide little or no tax incentives for superannuation, but the consequence of this is grossly inadequate private provision for retirement with subsequent undue reliance on an earnings related retirement benefit funded by government.

Chart 3.1: Effective tax rates on retirement savings in OECD countries



Source: OECD, 2004

Chart 3.1 sets out for the OECD countries the effective tax rates on savings outside superannuation (such as bank deposits) and on savings through employer sponsored private pensions (superannuation in the Australian vernacular). The darker bars are generally lower than the lighter bars, reflecting the tax concessions applying to superannuation/private pensions in almost all jurisdictions. Australia has the third highest dark bar (after Denmark and New Zealand) reflecting the relatively high effective rate of taxation on superannuation once the taxes at each of the stages of contribution, investment earnings and benefits are taken into account in the overall measure.

The OECD research also estimates that the aggregate overall budgetary cost in Australia in the year 2000 in terms of foregone personal income tax revenue arising from superannuation contributions made to be just under 1.6% of GDP. This percentage of GDP is less than comparable estimates for Ireland and the United Kingdom, and not much more than those for a range of other OECD countries, including the United States. Personal income tax cuts in Australia since 2000 also would have helped to moderate the aggregate cost.

The cost of tax concessions for superannuation also has to be considered in the context of overall government support for retirement income. Australia's expenditure on government funded Age and Veterans Pensions at just over 3% of GDP is one of the lowest levels of such expenditure amongst OECD countries and indeed most developed nations. Favourable demographics and a flat rate and means tested benefit structure are responsible for that. In a number of other developed countries the cost to government of expenditure on age related income payments is well over 10% of GDP and growing (European Commission, 2006).

In Australia the second pillar of retirement income, compulsory private provision, plays a greater role than in most other countries in achieving adequacy of retirement incomes. In many other countries government provided retirement benefits are linked to previous earnings in the labour force. In Australia private provision is needed to achieve this.

As a result Australia ranks about number four in terms of the largest private pension (superannuation) markets in the world, far above the ranking of Australia in terms of the largest economies around the world. **That the budgetary cost of tax concessions for superannuation is just above the average for other countries should not be surprising given the well above average reliance in Australia on private provision through both compulsory and voluntary superannuation contributions.**

3.3 Estimates of tax expenditures on superannuation in Australia

The Australian Treasury prepares each year its estimates of tax expenditures on superannuation (and other concessional tax treatments). The latest estimates were published in December 2005 (Treasury, 2005b).

The concept of a tax expenditure has been developed by Treasuries and Finance Ministries because accounting for the costs and benefits of tax measures can be less rigorous than for direct expenditures. However, as noted by the OECD (OECD, 1996) funded pension (superannuation) plans pose a particular problem for tax expenditure accounts, with a choice of possible benchmarks. The OECD also notes that countries' methods of dealing with these problems differ. Some countries, such as Germany and the Netherlands, do not, or have not, included data on pensions at all, on the basis that a comprehensive income tax base should not be applied in this area.

The Australian Treasury does apply the comprehensive income tax base in estimating tax expenditures on superannuation, coming up with an estimate of around \$15.5 billion in 2005-06 for funded superannuation arrangements. Treasury notes the estimates of tax expenditures are not necessarily indicative of the cost of superannuation concessions over the longer term, as taxes on superannuation pensions and lump sums will provide a greater offset to revenue foregone in future years, along with reducing future Age Pension expenditures. Both of these offsetting savings will increase substantially over time. As well, in the absence of adequate private supplementation of the Age Pension through compulsory contributions and tax concession there would be likely to be significant electoral pressures to increase the level of the Age Pension. The future budgetary costs of such an increase would be very substantial.

In addition, Treasury notes that the estimates cannot be interpreted as a time series of the ongoing amount of revenue that could be obtained if the superannuation concessions were eliminated. This is because the increase in tax revenue arising from the elimination of the tax expenditures with respect to a particular year would cause the superannuation tax base to be smaller for the next year. In other words, if superannuation was taxed like it was a personal bank account operated by an individual, then account balances and investment earnings would be a lot lower.

Another theoretical problem with the tax expenditure estimates is that, by taking tax on benefits paid in the year being considered from the tax relief provided for contributions and investment earnings, a major part of the dynamics of the tax collections is lost. If what we want to know is the present value of the costs over the lifetime of saving through superannuation then it would be much preferable to know what tax payments would be made on the benefit eventually paid. In a superannuation system in equilibrium where contributions are more or less equal to benefits paid this would not

much matter, but at a time when funds are still building up (and will continue to do so for decades to come) the cost of tax expenditures will be overestimated (Dilnot and Johnson, 1993).

If the tax expenditure estimate for superannuation were more rigorously prepared in that it took into account the future tax to be paid on superannuation benefits and offsets to social security expenditures, and was prepared on the basis of ongoing costs rather than an artificial point estimate, the estimate would be considerably lower. **Even accepting that the comprehensive income tax base is the appropriate base for calculating tax expenditures, making the appropriate adjustments described would reduce the annual tax expenditure estimate for superannuation from \$15.5 billion to around \$10 billion to \$11 billion.**

3.4 Summary

Australia with its TTT approach is out on its own in its treatment of private savings for retirement. It has one of the highest effective rates of taxation on such savings amongst OECD countries, and about the lowest aggregate government expenditure (including both direct expenditures and tax revenue foregone) as a percentage of GDP on retirement income provision. This suggests that there is both scope and need to remove the superannuation contributions tax in Australia.

4. The benefits flowing from abolition of the tax on superannuation contributions

Abolishing the tax on contributions would, especially compared to a cut in personal income tax rates, have a very favourable impact on retirement savings and retirement income adequacy, on national savings, and on the economy generally.

4.1 Impact on retirement income adequacy

Abolition of the tax on superannuation contributions would have a direct and positive impact on the retirement savings and the adequacy of retirement income for the nearly 9 million Australians currently receiving the benefit of employer or other tax deductible contributions. The impact would be even greater if the tax on investment earnings of superannuation funds were also abolished.

Tables 4.1 and 4.2 provide some worked examples prepared by the ASFA Research Centre of lump sums achieved for various income levels both before and after abolition of the contributions tax (and earnings tax). A 30 year working life is what many Australians will achieve on average, while 15 years with compulsory superannuation is what many recent retirees have.

Table 4.1: Lump sums achieved after 30 years(a)

Tax treatment	Wage of \$30,000	Wage of \$50,000	Wage of \$100,000
Contributions and investment earnings taxed at current rates	\$110,000	\$183,000	\$366,000
After benefits tax on lump sum	\$110,000	\$174,214	\$327,018
If no contributions tax (prior to benefit tax)	\$129,000	\$216,000	\$431,000
After benefits tax on lump sum	\$129,000	\$201,768	\$381,293
Improvement	\$19,000	\$27,554	\$54,275
If no contribution tax or tax on earnings	\$138,000	\$231,000	\$461,000
After benefits tax on lump sum	\$136,638	\$214,293	\$406,343

(a) All figures in today's dollars, investment earning rate of 7% assumed.

Table 4.2: Lump sums achieved after 15 years(a)

Tax treatment	Wage of \$30,000	Wage of \$50,000	Wage of \$100,000
Contributions and investment earnings taxed at current rates	\$43,000	\$72,000	\$144,000
After benefits tax on lump sum	\$43,000	\$72,000	\$141,648
If no contributions tax (prior to benefit tax)	\$51,000	\$85,000	\$169,000
After benefits tax on lump sum	\$51,000	\$85,000	\$162,523
Improvement	\$8,000	\$13,000	\$20,875
If no contribution tax or tax on earnings	\$52,000	\$87,000	\$175,000
After benefits tax on lump sum	\$52,000	\$87,000	\$167,534

For a person on a wage of \$30,000 per year, the direct impact of abolishing the contributions tax would, over a thirty year period, increase retirement savings by 17%, around \$19,000 in terms of today’s dollars. This would support an increase in retirement income of an annual amount of around \$1,000 indexed to the Consumer Price Index.

For a person on a wage of \$50,000 per year, the direct impact of abolishing contributions tax would, over a thirty year period, increase retirement savings by 16%, around \$27,500 in terms of today’s dollars. The retirement savings achieved would support an increase in retirement income of an annual amount of nearly \$1,650 indexed to the Consumer Price Index.

Elimination of the tax on contributions would considerably enhance the adequacy of savings for retirement. Currently the tax taken out of employer and other tax deductible contributions significantly erodes the net amount saved and invested for superannuation fund members. An individual receiving employer contributions at the standard Superannuation Guarantee rate of 9% of their applicable earnings only receives net contributions of 7.7% once the tax on contributions is taken out.

For those individuals who were subject to the superannuation surcharge, the erosion of contributions was even greater. The Government’s abolition of the surcharge on contributions made on or after 1 July 2005 reflected, amongst other things, a recognition of such concerns and the government’s interest in improving retirement income adequacy.

While ASFA (and the Australian community generally) has appreciated the abolition of the surcharge and the enhancement of the co-contribution from 2004-05 onwards, it notes that the budgeted contribution to superannuation accounts through the co-contribution totalling just under \$1 billion a year is dwarfed by total tax collections from contributions and fund earnings of over \$6 billion a year.

If the contributions tax were completely removed, it would reduce the percentage of salary needed to reach the retirement savings target put forward by ASFA and other commentators by 2 or 3%, making it considerably easier and more achievable for individuals. Research conducted by the OECD (OECD, 2005) also indicates that based on current policy settings in Australia prospective net replacement of income in retirement for a full-time career worker on average earnings would be both well below the OECD average and the replacement rate for many OECD countries.

So instead of having to save 15% of wages over 30 years to fund an adequate retirement income of around 60% of pre-retirement income, individuals would only have to save 12% or 13% over 30 years. Removing the tax would also provide an incentive for individuals to make additional salary sacrifice contributions or at the very least would remove what many regard as a disincentive.

As is apparent from the estimates contained in the tables above, ASFA is not proposing that the removal of the tax on contributions should lead to an increase in the tax on lump sum or pension benefits. Australia would still be a long way from the EET system of taxation applying in many developed countries due to continued application of tax on investment earnings. As noted in Section 3.2, superannuation is relatively highly taxed by OECD standards. What is needed is a reduction in the taxation level, not a shifting in the timing of tax collections. Otherwise the benefits of a removing the tax on contributions in terms of increasing the adequacy of retirement incomes would be greatly reduced.

4.2 Impact on incidence of individuals making salary sacrifice contributions

The evidence available indicates that the current level of tax incentives for superannuation contributions are not sufficient to support significant if any growth in salary sacrifice contributions, with indications that such contributions have been falling in aggregate in recent years. This is despite growth in the number of Australians employed and in nominal wages and salaries.

For instance, the Treasury (Treasury 2005a) has indicated that while the compulsory Superannuation Guarantee (SG) contributions from employers increased strongly between 1999-2000 and 2002-03 (up 59% from \$13 billion to about \$21 billion) additional contributions, made up of the total of employer contributions over and above the SG, member post-tax contributions and contributions from the self employed, grew only very modestly, from \$16 billion to \$18 billion. For some age groups contributions over and above compulsory employer contributions fell. Treasury figures indicate that additional contributions for those aged under 40 fell from \$2.6 billion a year to \$2.4 billion a year between 1999-2000 and 2002-03. Around \$800 million of this latter amount involved post-tax contributions, with the remaining \$1.6 billion either salary

sacrifice or employers otherwise paying contributions at a rate in excess of 9% of wages.

Separate survey data collected in September 2005 for ASFA by ANOP (ANOP, 2005) indicate that 21% of the workforce currently engage in some sort of salary sacrifice arrangement. The incidence of this increases with age. Only 15% of those aged 25 to 34 currently undertake salary sacrifice, rising to 30% for those aged 55 to 64.

While the introduction of the co-contribution and the abolition of the surcharge have gone at least part of the way in encouraging voluntary superannuation contributions, the effective rate of tax on superannuation contributions has continued to inhibit salary sacrifice contributions, particularly by those on middle incomes. The level of tax concession available clearly have an important impact on converting consideration of salary sacrifice to action. For a person on a personal income tax rate of 30%, the existence of the tax on contributions together with the tax applying to certain benefits makes salary sacrifice a very marginal proposition, particularly given the preservation requirements applying to superannuation contributions.

ASFA considers that it is this middle income group in particular which deserves assistance, especially given that they have not benefited from either the abolition of the superannuation surcharge or the initial two versions of the co-contribution. As noted by Treasury researchers in a recent paper (Bingham and Rothman 2005), the current co-contribution provides a good incentive for individuals on relatively low wages, while the abolition of the surcharge restores some tax advantages for those who are higher paid.

Removal of the contributions tax would provide an effective incentive for middle income earners (and others with superannuation) to arrange for salary sacrifice or other tax deductible contributions to be made on their behalf. For those on a 30 cents in the dollar personal income tax rate, abolition of the contributions tax would make salary sacrifice a viable proposition. Without abolition of the tax, salary sacrifice is a very marginal proposition for this group given preservation requirements and taxes at the benefit stage.

The 2005 ANOP research found interest amongst those not currently making salary sacrifice contributions in making such contributions in the future to be relatively high amongst middle income earners, with 39% of those with household income between \$40,000 and \$59,000 indicating interest. This compares to 26% of those with household income in excess of \$100,000 expressing interest. Those on higher incomes tend to be less concerned about adequacy of retirement income, and also generally have a range of other savings options available.

Interest in making salary sacrifice (amongst those not currently making such contributions) also tends to be highest amongst those aged under 45. Interest is fairly evenly split between men and women.

Making or increasing salary sacrifice contributions as the result of the removal of the contributions tax is also consistent with the findings of 2004 ANOP research which indicated that most respondents saw the primary responsibility for increasing superannuation contributions being on the individual, but with the government also

being seen to be a major player. **Encouraging further contributions through removal of the contributions tax or expansion of the co-contribution would be a practical application of these majority community views.**

4.3 Impact of removal of the contributions tax on private and national savings

An argument sometimes raised is that removal of the contributions tax is not justified on economic grounds on the basis that the decline in public savings involved would be greater than the increase in private savings. However, on the basis of this argument it would be difficult if not impossible to ever justify having a decrease in any tax or an increase in any expenditure.

The reality is that abolition of the tax on contributions would have a more favourable impact on national savings than any other feasible budget proposal. In this context, Reserve Bank research (RBA, 2004a) indicates that the marginal propensity to save out of labour income is 13 cents in the dollar. **If there were a cut in personal income tax, then it could be expected that for each one dollar cut in tax there would only be 13 cents additional private savings. This implies a decline in national savings of around 87 cents for each dollar of personal income tax.**

However, **of all possible tax or expenditure proposals, a decrease in or elimination of the tax on superannuation contributions is the measure most likely to generate an increase in national savings, or at least no significant diminution.** There are a number of reasons for this. First, there is substantial preservation of superannuation savings until a condition of release is satisfied, generally retirement. A tax cut which directly feeds into superannuation account balances is generally unable to be spent on consumption items, at least not for a very long time after it is contributed.

Second, while some households might decrease other voluntary savings as a result of increased compulsory savings through superannuation, many households face a liquidity constraint. If you are already not saving and indeed are borrowing, then an increase in net superannuation contributions has little or no effect on household behaviour. Even if a household wanted to borrow more as a result of feeling richer because of a cut in the tax on superannuation contributions, it would be unable to do so because a lender would not count the superannuation tax cut as part of the household income available to repay a loan.

Using Reserve Bank research findings, for each additional dollar in superannuation savings private savings would increase by 62 cents.

Based on these figures and a tax cut of similar amount (\$3.3 billion), **abolition of the contributions tax would boost private savings by at least \$2 billion, compared to \$430 million for an equivalent cut in personal income tax.** The differential could be even greater, as abolition of the contributions tax is likely to lead to the diversion of some private consumption into saving through additional salary sacrifice contributions, rather than just shifting the composition of private saving of the minority undertaking substantial saving outside superannuation.

In this context, as noted in Section 4.2, there is considerable interest in the community in making new or additional salary sacrifice contributions, especially if the government does something to assist this to happen. Some 34% of respondents in the 2005 ANOP survey indicated that they would consider salary sacrifice contributions, with interest particularly high amongst middle income earners and younger persons. However, the actual percentage of individuals who would start or increase salary sacrifice contributions would be likely to be well below the 34% figure as the usual conversion rate of stated intentions or consideration of an option tends to be well under 100%.

4.4 Impact on investment and the real economy

Australian superannuation funds play a large and increasing role in the health of Australia as a nation and in the strength of its economy. **Super savings support investment and growth in GDP. Super savings also help ensure Australia's independence and provide a buffer against undue reliance by Australia on overseas financing. Abolishing the tax on contributions would strengthen these roles.**

Superannuation contributions are invested by superannuation funds in a range of activities that help build jobs, Australia's infrastructure, business and venture capital.

Funds have a diversified investment strategy across a range of asset classes. This delivers the best returns over the longer term for individuals and for the economy.

Superannuation assets invested in Australian equities have more than tripled since 1995. Funds have also been an important source of finance for both traditional and emerging companies, and will continue to do so into the future.

Investments in Australian shares by superannuation funds now account for around 30% of the market capitalisation of companies listed on the ASX (up from 25% in 1995). As well, superannuation funds account for nearly 50% of the \$3.7 billion invested in unlisted venture capital funds, far ahead of banks and private investors.

Importantly for the economy, superannuation funds have a longer-term investment perspective than many other investors and are able to invest in areas where the full investment return may take some time to be delivered. Accordingly, superannuation funds are amongst the largest investors in the private provision of infrastructure in Australia, with investments in trusts and other investment vehicles which own airports, toll roads, power generating facilities and the like.

Superannuation funds also make very significant investments in commercial real estate, including office blocks, retail shopping centres and factory and other developments. Some funds with many members in the building sector are particularly involved in facilitating the financing of new building projects. Financing arrangements which provide home loans to superannuation fund members also support the residential housing sector.

A number of superannuation funds also pay particular attention to the regional impact of investments, and allocate a proportion of their investment portfolio to investments in regional Australia. To the extent that super investments help in the strength of the economy this flows to all regions and parts of the economy.

5. Equity implications of doing away with tax on superannuation contributions

A very few commentators have from time to time raised doubts about the equity implications of removing the tax on contributions. In particular, such commentators claim that the bulk of benefits would flow to higher income earners. However, when the detailed data are examined such doubts are not justified. **The great bulk of the benefits of removing the tax on superannuation contributions would go to low and middle income earners.**

5.1 The distribution of superannuation contributions by income level

Nearly 70% of superannuation contributions are made by or on behalf of individuals who will be on a marginal tax rate of 30 cents in the dollar or less after 1 July 2006. Nearly 90% of contributions will relate to individuals on less than the top marginal tax rate.

This is shown in Tables 5.1 and 5.2, which set out amongst other things ASFA Research Centre estimates of the proportion of superannuation contributions made on behalf of taxpayers in the various marginal income tax bands applying after 1 July 2006. As well, there is not necessarily anything wrong with providing some tax relief for upper income earners. Equity has a number of dimensions, and increasing (or maintaining) tax rates on upper income earners can lead to less rather than more equity within a taxation system, particularly when there are other equity measures in place, such as limiting access to the Age Pension on the basis of an assets and income test.

Table 5.1: Personal income tax scale and distribution of employer contributions by income range, July 2006

Taxable income range (\$)	Marginal income tax rate (2006-07)	%of taxpayers	% of wages and salaries	%of employer contributions
0 - 6,000	0%	21	1.5	0
6,001 - 21,600	15%	20	8	5
21,601 - 70,000	30%	52	67	62
70,001 - 125,000	42%	6	15	22
125,001+	47%	2	8	11

Based on 2002-03 ATO Taxation Statistics and July 2006 tax rates together with estimates contained in 2005-06 Budget Speech by the Treasurer.

Table 5.2: The distribution of non-employer sponsored, tax deductible superannuation contributions by income range, July 2006(a)

Taxable income range (\$)	Marginal income tax rate (2006-07)	%of contributions
0 - 6,000	0%	0
6,001 - 21,600	15%	4
21,601 - 70,000	30%	40
70,001 - 125,000	42%	45
125,001+	47%	11

Based on 2002-03 ATO Taxation Statistics and July 2006 tax rates

The changes to the tax scales mean that after July 2006 the tax incentive for contributing to superannuation will be less than it used to be, as there will be far fewer taxpayers on the top tax rate, with the volume of superannuation contributions associated with those on the top tax rate accordingly down as well. While individuals who will be on lower marginal tax rates than they were before will be unequivocally better off in terms of take home pay, the gap between the marginal income tax rate of many individuals and the effective rate they face in regard to their superannuation will be reduced.

More specifically, **compared to five years earlier the volume of superannuation employer contributions associated with employees on the top marginal tax rate will be down from 28% of employer superannuation contributions to 11% of contributions. On the other hand, the proportion of contributions where the employee is on a marginal income tax rate of no more than 30% has increased from around 62% to 67%.**

While there is nothing necessarily wrong with reductions in personal income tax rates, it has led to a reduction in comparative tax advantage of superannuation. **Compared to five years ago, the average weighted marginal personal income tax rate of superannuation fund members has come down from about 39% to around 34%.** If the differential in tax rates between personal income tax and superannuation was about right before, by definition there will be a need to reduce the tax on superannuation contributions applying after 1 July 2006.

Tables 5.1 and 5.2 above also do not provide any evidence of any gross horizontal or vertical inequity in regard to the provision of employer contributions or otherwise tax deductible superannuation contributions. Superannuation contributions are made for nearly all full-time and many part-time employees, and their distribution across the labour force is largely in line with the distribution of wage and salary incomes. Any dispute with the distribution of superannuation contributions and their associated tax concessions is largely a dispute about the distribution of wages and salaries.

Some commentators have difficulties with the distribution of salaries in Australia, with recent attention being given to executive salaries in particular. However, the distribution of earnings in Australia is not marked unequal by international standards. **In any event, arguing against removal of the contributions tax because it would**

benefit upper income earners ignores the fact that around 70% of the benefit of removing the contributions tax would flow to low to middle income earners.

The difference between the tax on contributions and the tax on personal income is only one part of the equity position of an individual, both in absolute terms and relative to other individuals. There also are a number of other provisions in the superannuation, taxation and social security systems designed to deliver overall equity. The next section details these.

It should also be kept in mind that the greatest challenge in regard to the accumulation of private savings for retirement is achieving an adequate level of savings. Inadequate savings for retirement are all too common in Australia, whereas an excess level of tax advantaged savings for retirement is very much a rarity and in any event is dealt with by the Reasonable Benefit Limits arrangements.

5.2 Distribution of superannuation balances by level of total wealth

Concessional tax treatment of superannuation along with compulsory contributions has the capacity to reduce inequality in both wealth and retirement incomes. Superannuation forms a large part of the financial wealth of the lower wealth and income groups. Those without housing equity, usually the young and/or those at the lower end of the income distribution, very often have no savings apart from superannuation. In contrast, for the 30% of households with the most wealth, superannuation generally forms 20% or less of household wealth.

As well, according to recent RBA research (RBA, 2004b) there is not a strict correlation between income and wealth. Some low income households have substantial wealth, while 56% of households in the highest income quintile are not in the wealthiest quintile. **Superannuation and life insurance account for around 55% of household financial assets, with relative importance lower for the wealthiest quintile. The wealthiest quintile has substantial holdings of equity investments and trusts, with the poorest quintile having very low levels of these.**

Removing tax from superannuation contributions would have the potential to reduce wealth inequality as it would have its greatest relative impact at the lower ends of the wealth distribution. For the lowest part of the wealth distribution, developments in the real level of the Age Pension will continue to be the most important influences on income and living standards in retirement.

In effect, entitlement to the Age Pension or the Veterans Pension forms the greatest part of the “wealth” of the majority of the retired. At current market rates, the cost of purchasing an annuity at retirement equivalent to the Age Pension is in excess of \$200,000 for a male, and over \$250,000 for a female, reflecting the longer life expectancy of women. Inclusion of this form of “wealth” results in a much more even distribution of wealth being recorded.

Rice, 1998 has estimated that the then present value of the Age Pension, rent relief and the Veterans Pension was \$172 billion in 1997. This compares to assets in

superannuation at that time of \$333 billion and total wealth of \$1,500 billion. That figure on the present value of government income payments to the aged would be much greater if it were updated to the situation in 2005-06.

The present value of government pensions was based on market rates for annuities at that time, and assumed that average earnings would outstrip pensions by 2% per annum. On the basis of current annuity rates and assuming that Age Pensions will continue to be indexed to Average Weekly Ordinary Time Earnings (AWOTE), the current present value of Age and Veterans Pensions is in excess of \$200 billion.

6. System design features reinforcing the equity of a cut in the tax on contributions

The very few critics of the proposal to cut the tax on contributions have raised concerns that upper income wage and salary earners might make undue use of the ability to make contributions from pre-tax income. Apart from the fact that the bulk of benefits of the tax cut would clearly flow to low and middle income earners, there are a number of design features of the superannuation system which would prevent an excessive level of contributions being made by or on behalf of upper income earners. These features are described below.

This section also discusses the impact (or lack thereof) of removing the contributions tax on the 15% rebate for certain superannuation pensions and annuities.

6.1 Age based contribution limits

There have been long standing limits on the extent to which employers can claim tax deductions for superannuation contributions made on behalf of their employees. These have been part of the controls which limit tax expenditures benefiting high-income individuals. Various formulae have been used, but since the 1996 Budget age based contribution limits have applied. These limits are indexed in line with Average Weekly Ordinary Time Earnings (AWOTE). For 2005-2006 the maximum deductible contribution for members aged under 35 is \$14,603, for those 35 to 49 it is \$40,560 and for those age 50 and over it is \$100,587.

The limits on deductible contributions constrain the ability of individuals to undertake excessive levels of salary sacrifice, particularly by those aged under 35. While the limit is sufficient to allow contributions to be made consistent with Superannuation Guarantee obligations up to the maximum earnings base for SG purposes, there is relatively little leeway. More specifically, the maximum compulsory Superannuation Guarantee for those earning \$134,880 takes up nearly 85 per cent of the deductible contribution limit for those aged under 35. ASFA has in various submissions identified the need for some increased flexibility for younger age groups.

For those who are older there is considerably more flexibility. However, only a very small number of individuals would have a remuneration package to support, or inclination to have, employer contributions of large amounts to be made on their behalf. While the current limit for those aged 50 and over allows catch up for those who have not had good superannuation in the past, given that it is now some 14 years since compulsory superannuation was introduced through the Superannuation Guarantee it

would be possible to moderate that figure to a lower level if there were concerns about possible levels of salary sacrifice following abolition of the tax on contributions. As well, salary sacrifice at high levels on top of previous and continuing compulsory employer contributions would generate benefits in excess of the Reasonable Benefit Limits, with an associated clawing back of tax benefits.

6.2. Reasonable Benefits Limits (RBLs)

Restrictions on the total benefits that can be received from a superannuation fund without loss of concessionary tax treatment have been a long established feature of the superannuation system. The basic rationale is that only a certain amount of benefits are needed to fund a reasonable standard of living in retirement, and benefits above that level should be taxed in such a way that no concession is delivered.

Since 1994 RBLs have been based on absolute limits rather than being a multiple of the final salary of an individual, the system which previously applied. Fixed dollar RBLs cap the maximum tax concession available for all fund members. For 2005-06 the reasonable benefit limit is \$648,946 for benefits received as a lump sum, while the limit of \$1,297,886 applies where at least 50% of the total benefit received by a person is taken in the form of a complying pension or annuity. Both amounts are indexed each year in line with movement in average weekly ordinary time earnings (AWOTE).

The pension RBL is in broad terms consistent with a private retirement income in pension form of just over \$60,000 a year, but the exact equivalence depends on the gender of the member, the characteristics of the pension taken and the age at which it starts, and on the current market price for pensions and annuities (with this linked to investment returns and the degree of competition between providers).

The lump sum RBL clearly is much lower, but it does allow the member access to capital, thereby raising the likelihood that the member will rely in whole or in part on the Age Pension at some point during their retirement. However, anyone with a superannuation balance in the region of the lump sum RBL will not qualify for the Age Pension or other social security while they have access to that balance.

How long a lump sum will last and what level of income drawdown it will support depends on a number of factors. However, one calculation, drawn from an on-line calculator on the AMP website, indicates that **superannuation savings equal to the 2005-06 lump sum RBL would allow a 60 year old male to draw down the sum of \$44,973 over their life expectancy of just over 21 years, with the annual drawdown adjusted upwards for inflation each year. This amount is less than the \$46,192 a year needed by a couple as at December 2005 to pay for a comfortable lifestyle in retirement as shown by the Westpac-ASFA Retirement Living Standard.**

While both the pension and the lump sum RBLs appear at first glance to be relatively large amounts in absolute terms, the annual drawdowns they support over the 20 or more years the average person has in retirement are relatively modest in scale. **In essence, the RBLs mean that tax concessions for superannuation are capped at a level which is not excessive.** Very wealthy individuals may make use of superannuation to some extent, but most of their wealth will be elsewhere.

6.3 Tax free threshold for lump sums

The tax free threshold for lump sums was first introduced in 1983 when eligible termination payment (ETP) taxation arrangements were put into effect. Previously, only 5% of superannuation and various termination payments were included in assessable income, regardless of the age at which they were received. After 1 July 1983 the full amount of any benefits accruing after that date was included subject to a maximum marginal rate of 30%. As well, in order to encourage the preservation of benefits until retirement, the tax rate on the first \$50,000 of the post-June 1983 component was reduced to 15% provided the recipient had attained the age of 55.

The threshold amount for the higher rate of taxation was increased to \$55,000 in 1985-86 and to \$60,000 in 1988-89. The year 1988 also saw major changes to the taxation of superannuation funds and of superannuation and other termination payments. A 15% tax was introduced on all contributions other than personal contributions not receiving the benefit of a tax deduction when made, and the tax on the post-1983 component was reduced from 30% to 15%. Logically, the rate on the first \$60,000 was reduced to zero. By 2005-06 the tax free threshold had reached \$129,751, and this is indexed annually in line with growth in average earnings.

This tax free threshold has an important equity impact. For instance, a person on average earnings who achieves a lump sum of \$170,000 in terms of today's dollars would incur a tax liability in the order of \$6,040 in benefit tax, an effective tax rate of 3.5%. However, an individual who achieves a lump sum equal to the lump sum RBL would pay \$77,880, an effective rate of 12% on the benefit.

The tax free threshold provides a substantial contribution to the equity of the tax treatment of superannuation. For a substantial number of low income individuals who have accrued very modest superannuation entitlements, the existence of the threshold is essential in order to provide a measure of equity in terms of the total taxation of contributions, earnings and benefits. A lump sum benefit (rather than a pension or other income stream) is also likely to be the only viable form of benefit when a relatively modest sum is involved.

As noted in Section 3.2, ASFA is not proposing that removal of the contributions tax lead to any increase in the taxation of lump sum or pension benefits.

6.4 The 15% tax rebate for certain income streams

The 15% tax rebate for certain income streams has a somewhat convoluted history. Prior to 1 July 1983 only 5% of the amount received as a lump sum payment on termination of employment was taxed. In contrast all of a pension or annuity payment (apart from the deductible amount reflecting the return of capital) was assessable. Pension provision was assisted though by the income of superannuation funds being tax exempt, boosting the earnings which supported the payment of pensions and annuities. Because lump sums received such favourable tax treatment, and the more generous schemes provided only pension benefits, it was rare to see substantial deductible amounts in regard to pensions.

In July 1983 this relativity was altered by increasing the taxation of lump sums, with a maximum rate of 30% and a rate of 15% for the first \$50,000 of lump sum benefits. The tax treatment of pensions was largely left alone. However, effective from 1 July 1988 the tax rates on the post-1983 component of lump sums were respectively reduced from 30% to 15% and from 15% to zero, with the introduction of tax on contributions (other than undeducted contributions) and earnings at the fund level.

The balance between lump sums and pensions/annuities was disturbed by this reduction in tax. Hence the then government introduced a 15% rebate to apply to the post-1983 portion of a pension or annuity, and exempted the income earned on assets set aside by a fund to pay pensions from taxation at the fund level. In regard to the latter, exempting fund earnings was necessary in order to maintain the relativity with lump sums and to avoid the double taxation of investment earnings taken in the form of a pension.

A number of commentators raise the existence of the 15% rebate as a reason not to abolish the current tax on contributions (and fund investment earnings) during the accumulation phase. Their reasoning is that the 15% rebate is a very valuable provision which largely neutralises the initial impact of superannuation taxes, and that the rebate would need to be removed if the tax on contributions were removed. However, this argument does not necessarily follow.

The 15% rebate is valuable for some, but the numbers benefiting are not large compared to those bearing the cost of the tax on contributions. As well, the benefit of the rebate is largely wasted for many self funded retirees as they are also eligible for the Senior Australian Tax Offset, which removes any obligation for those of Age Pension eligibility age to pay income tax in 2005-06 if their income is less than \$21,968 for a single person, and less than \$36,494 for a married couple combined. For individuals and couples receiving the benefit of a funded superannuation pension of less than those amounts, the 15% rebate is essentially wasted as it is only an offset against a tax liability and is not refundable. It differs from refundable imputation credit applying to certain franked company dividends.

Tax data for 2002-03 indicate average rebates for those receiving annuities and pensions of \$1,970 for the 315,000 recipients. While there was some spread in the taxable incomes of those eligible for the rebate, most (around 200,000 taxpayers) had taxable income of less than \$35,000 a year, with only around 58,000 recipients having taxable incomes of over \$50,000. While the rebate is of assistance in achieving an adequate standard of living in retirement for a sub-set of retirees, it plays only a modest role in the overall scheme of things.

In terms of the balance of tax received and rebated by the government, currently the government receives over \$6 billion a year, and rebates \$620 million to recipients of pensions and annuities. Even then a large part of the \$620 million is only a nominal rebate, as most recipients with taxable incomes under \$35,000 a year have little or no tax liability to offset as their tax liability has already been dealt with in whole or in part by the Senior Australian Tax Offset or the other tax measures dealing with those on relatively low taxable incomes.

It is clear that existence of the 15% tax rebate for those with allocated pensions and the like in no way justifies the up-front taxation of superannuation contributions and fund

investment income. The government takes over \$6 billion, but only gives back around \$350 million when the effect of other available rebates are taken into account.

ASFA acknowledges that the rebate is valuable for those who are able to make use of it, and it is of assistance in bringing about greater adequacy of retirement incomes, at least for some. ASFA is opposed as a matter of policy to abolishing the rebate even if all the tax on contributions were abolished. There are a number of reasons for this. First, for many years to come retirement savings will have experienced the effects of the taxation of contributions (and the surcharge for some) from the time they applied to the time when the contributions tax is finally abolished. Second, retirement savings will continue to suffer from the effects of the tax on fund investment earnings. This is a substantial part of the taxation take from superannuation (see Section 1). Third, most retirement savings will continue for many years yet to be insufficient to support a comfortable standard of living in retirement, and the rebate provides assistance for some in achieving a more adequate retirement income. Fourth, the rebate provides an incentive for taking a retirement benefit in an income stream form, which is in the interests of both fund members and the government.

Finally, there is the pragmatic reason of avoiding a new transition date in the superannuation system. Otherwise equity would require a rebate being available for an income stream attributable to post-1983 to date of abolition of contributions tax contributions but not for the component attributable to contributions after that date.

6.5 The claw back of social security benefits when final retirement savings are higher

The operation of the means test for the Age Pension also reinforces the equity outcomes if the tax on superannuation contributions was abolished.

Eligibility for the Age Pension is an important part of the provision of retirement income system in Australia. Currently the bulk (just under 70%) of persons aged over eligibility age (65 for men, increasing from 60 to 65 for women) receive at least some Age Pension.

Both income and asset tests apply to entitlement to the age pension, with a single person receiving no age pension if their income exceeds \$35,476 per year or if they have greater than \$322,000 in assets and are a homeowner. For a couple these figures are \$59,325 and \$497,500 respectively. Higher limits apply to non-homeowners, and the Age Pension begins to be phased out at lower income and asset levels in all these cases. For a single homeowner the amount of Age Pension begins to reduce when the individual has more than \$157,000 in assets, with the figure for couples \$223,000. The rate of withdrawal effectively is 40 cents in the dollar of additional income, and \$78.20 a year less in pension for every additional \$1,000 in assets over the threshold.

If anything, the income and asset tests are reasonably severe on individuals receiving more superannuation retirement benefits in aggregate which are above the asset test thresholds, in that an individual needs to achieve investment earnings above 7.8% per year or have some assets not counted fully in the means test (such as in a complying pension) in order to avoid a net reduction in retirement income from higher private savings.

So in broad terms removal of the contributions tax would feed directly into the retirement savings of those with modest financial assets including superannuation (under \$150,000 for a single person and under \$220,000 for a couple) without any impact on Age Pension entitlement. For those with more substantial financial assets (\$150,000 to \$320,000 for a single person and \$220,000 to \$495,000 for a couple) abolition of the contributions tax would boost retirement savings but there would be some offset in Age Pension entitlement. For those relatively few individuals with financial assets in excess of the upper thresholds described above, they miss out entirely on the Age Pension and have to manage their Reasonable Benefit Limit situation, and they pay a certain amount of income tax on their retirement income, unlike the other groups with lower incomes and retirement savings.

6.6 The combined impact of the various equity measures

The current regime of equity measures, consisting mainly of the aged based contribution limits, the tax free threshold for benefits, the means test applying to the Age Pension and the Reasonable Benefit Limits on superannuation benefits, is not the most elegant way of dealing with equity concerns. If you were starting from scratch in order to develop a simple and coherent approach to equity a somewhat different approach could well be adopted. However, starting from scratch is not a luxury ever experienced in regard to superannuation. **What is in place is not pretty or simple, but fortunately it does more or less adequately deal with equity.**

Individuals with low balances of superannuation pay no benefit tax on their superannuation benefits and they also generally will receive the full Age Pension. Those with moderate levels of superannuation will pay a modest amount of benefit tax and generally will receive a part Age Pension. Those with relatively large superannuation benefits pay a significant amount of benefit tax on a lump sum or pay ongoing income tax (albeit at a concessional rate) on an income stream, receive no Age Pension and face withdrawal of tax benefits on any amount over the applicable Reasonable Benefit Limit.

7. Summary

In summary, abolition of the tax on employer and other tax deductible contributions would be a sound policy to adopt. It would:

- be affordable, with a cost to revenue in the order of \$3.3 billion compared to a prospective Budget surplus of over \$10 billion in 2006-07;
- better meet the needs of intergenerational equity requirements than the current approach to taxation, as additional net contributions into the superannuation would reduce pressures arising from future government expenditures on the Age Pension, and through the taxation of end benefits would strengthen the revenue base of future governments;

-
- bring the taxation treatment of superannuation (private pensions) more in line with international practice, and reduce the effective rate of tax on saving through superannuation to a level more comparable with other developed countries;
 - make a substantial contribution to improving adequacy of future retirement incomes and in tackling the current savings gap;
 - increase both private and national savings, especially compared to a personal income tax rate reduction;
 - add to the stock of funds being invested in Australia, leading to increased employment and economic activity; and
 - most importantly be equitable, delivering significant benefits to low and middle income earners.

References

Access Economics, 1998; *Cost of Superannuation Tax Concessions*, Canberra, September 1998.

Access Economics, 2004; *Intergenerational Modelling for Australian Families*, Canberra, April 2004.

ANOP, 2004, ANOP Research Services Pty Ltd, *Report on Community Attitudes to Saving for Retirement*, Sydney, August 2004.

ANOP, 2005, ANOP Research Services Pty Ltd, *Report on Attitudes to Super and Choice of Fund in Late 2005*, Sydney, November 2005.

ASFA, 2005, Association of Superannuation Funds of Australia, *Pre-Budget Submission for the 2006-07 Budget*, Sydney, December 2005.

ATO, 2005, Australian Taxation Office, *Taxation Statistics, 2002-03*, Canberra, 2005.

Bingham, Cliff and Rothman, George, 2005, *Incentives to Save More in Superannuation*, Paper to the Thirteenth Annual Colloquium of Superannuation Researchers, University of New South Wales, July 2005.

Costello, 2006, The Hon Peter Costello, MP, Treasurer, *The Australian Revival*, Address to the National Press Club, 1 March 2006, Canberra.

Dilnot and Johnson, 1993, Andrew Dilnot and Paul Johnson, *Tax Expenditures: The Case of Occupational Pensions*, Fiscal Studies (1993) Vol 14, No. 1, London.

European Commission, 2006, *The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment (2004-2050)*, February 2006.

Minchin, 2006, Senator the Hon Nick Minchin, *Address to the 2006 Federal Young Liberal Convention*, January 2006
(http://www.financeminister.gov.au/speeches/2006/sp_20060122_youngliberal.html)

OECD, 1996, Committee on Fiscal Affairs, *Tax Expenditures: Recent Experiences*, Paris.

OECD, 2004, Kwang-Yeol Yoo and Alain de Serres, *Tax Treatment of Private Pension Savings in OECD Countries*, OECD Economic Studies No 39, 2004/2, Paris.

OECD, 2005, *Pensions at a Glance: Public Policies across OECD Countries*, Paris.

Productivity Commission, 2005, *Economic Implications of an Ageing Australia*, Research Report, March 2005, Canberra

RBA, 2004a, Ellis Connolly and Marion Kohler, Economic Research Department, Reserve Bank of Australia, *The Impact of Superannuation on Household Saving*, Research Discussion Paper 2004-01, Sydney, March 2004.

RBA, 2004b, Reserve Bank of Australia, *The Composition and Distribution of Household Assets and Liabilities: Evidence from the 2002 HILDA Survey*, Reserve Bank of Australia Bulletin, April 2004.

Rothman, George, 2003, *Tax Advantages of Investment in Superannuation – In Bad Times as well as Good*, Paper to the Twelfth Annual Colloquium of Superannuation Researchers, University of New South Wales, July 2004.

Treasury, 2005a, *Submission to the House of Representatives Economics, Finance and Public Administration Committee inquiry into improving the superannuation savings of those aged under 40*, Canberra 2005.

Treasury 2005b, *Tax Expenditures Statement*, Canberra, December 2005.